IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF VIRGINIA
Newport News Division

IN RE LUMBER LIQUIDATORS HOLDINGS, INC. SECURITIES LITIGATION	)	Master File No. 4:13-cv-00157-AWA-DEM Hon. Arenda L. Wright Allen CLASS ACTION

MEMORANDUM IN SUPPORT OF DEFENDANTS' MOTION TO DISMISS PLAINTIFFS' CONSOLIDATED AMENDED COMPLAINT

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Lumber Liquidators Holdings, Inc. ("Lumber Liquidators" or the "Company"), Robert M. Lynch, Daniel E. Terrell, Thomas D. Sullivan, and William K. Schlegel ("Individual Defendants"; with Lumber Liquidators, "Defendants"), hereby move to dismiss Plaintiffs' Complaint with prejudice under Federal Rule of Civil Procedure 12(b)(6).[1]

INTRODUCTION

Lumber Liquidators is the largest specialty retailer of hardwood flooring in North America. In 2012 and 2013, the Company expanded its operations and enjoyed unprecedented financial success. As a result, the Company's stock price increased significantly, nearly doubling in 2013 alone. In conjunction with this rise in fortunes, however, the Company also attracted short sellers, who were eager to profit from generating negative publicity that would reverse some or all of that stock price increase.

In June 2013, an internet post from a professed short seller alleged that the Company's laminate flooring products might not be in compliance with formaldehyde emissions standards. Subsequently, in September 2013, an environmental group provided the government with an advance copy of a report alleging that the Company had imported illegally harvested wood. With this prompting, the government executed search warrants related to the allegations. Another short seller, named Whitney Tilson, gave a public presentation in November 2013 stating that, in his opinion, formaldehyde and illegal harvesting issues could disrupt the Company's supply chain and impact its margins. Finally, in 2015, Mr. Tilson (after increasing his short position in 2014) convinced a prominent CBS television show, *60 Minutes*, to run an investigative report on Lumber Liquidators claiming that CBS had tested the Company's laminate products and found high levels of formaldehyde. Not surprisingly, in the face of this drumbeat of negative publicity, Lumber Liquidators' stock price declined.

Negative publicity, however, is an insufficient basis for a securities fraud claim. Plaintiffs are reduced to asserting that because Lumber Liquidators has been *accused* of having

[1] "Complaint" or "Compl." refer to Plaintiffs' Consolidated Amended Complaint. ECF No. 80.

engaged in regulatory violations, those accusations are enough to adequately allege that (a) widespread regulatory violations occurred and (b) the Company's senior officers knew about the widespread regulatory violations and hid their financial impact from investors. Plaintiffs are wrong.

Under the Private Securities Litigation Reform Act of 1995 (the "PSLRA"), securities fraud claims are subject to heightened pleading standards that Plaintiffs completely fail to meet. *First*, Plaintiffs do not, because they cannot, plead the required strong inference of scienter as to any of the Defendants. The Complaint is devoid of any allegations as to how Defendants knew, or were severely reckless in not knowing, about any regulatory violations or their financial impact. Indeed, Plaintiffs' formaldehyde-related claims amount, at best, to an inactionable dispute over the adequacy and meaning of various formaldehyde testing procedures. Plaintiffs also fail to demonstrate that the Defendants had any relevant motive to commit fraud.

Second, Plaintiffs do not provide any factual allegations demonstrating that Lumber Liquidators' statements about its regulatory compliance programs and historical financial performance were false or misleading.

Finally, Plaintiffs cannot establish loss causation based on allegations that stock price declines occurred as the result of the internet post, the announcement of the government investigation, the short seller presentation, or the *60 Minutes* report. While these disclosures created negative publicity for the Company, they were not "corrective disclosures" that provided the required "new facts" alerting the market to the fraud alleged in the Complaint.

Securities fraud claims do not exist "to provide investors with broad insurance against market losses." *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 345 (2005). If a successful case could be brought every time a company is accused of having engaged in regulatory violations, the courts would be awash with securities litigation. Plaintiffs have failed to provide *any* facts to support their assertion that Defendants knowingly engaged in a fraudulent scheme to import illegal or hazardous wood products to inflate the Company's gross margin and then hid that scheme from investors. Indeed, this is exactly the type of speculative securities fraud claim that

Congress sought to prevent when it passed the PSLRA. Defendants respectfully request that the Court dismiss Plaintiffs' claims with prejudice.

BACKGROUND[2]

The Company's Business – Lumber Liquidators is the largest specialty retailer of hardwood flooring in North America. (2014 Form 10-K at 2, Ex. 1); *see also* Compl. ¶ 6. The Company offers an extensive assortment of exotic and domestic hardwood species, engineered hardwood, laminate, vinyl plank, bamboo, and cork direct to the consumer. *Id.* It also provides a wide selection of flooring enhancements and accessories, including moldings, noise-reducing underlay, adhesives, and flooring tools. (2014 Form 10-K at 4, Ex. 1.) The Company's primary customers are homeowners or contractors acting on behalf of homeowners. (2014 Form 10-K at 7, Ex. 1); *see also* Compl. ¶ 6.

The Company is well-diversified in its product sources, in terms of both geography and number of suppliers. From 2012 to 2014, approximately half of the Company's sales were of products sourced in North America, with the other half coming from Asia (plus a small additional percentage from South America, Europe, and Australia). (2014 Form 10-K at 4, Ex. 1.) In 2014, 43% of these products were hardwood (solid and engineered), with less than 2% of that hardwood consisting of oak purchased from northern China. (Business Update presentation at 42, attached to March 12, 2015 Form 8-K, Ex. 2.)

A number of changes to Lumber Liquidators' business from 2011 to 2013 led to an

[2] As is permitted in securities fraud cases, this factual background is drawn from all well-pleaded facts, judicially noticed matters, and documents central to or referred to in the Complaint. On a motion to dismiss, "a court may consider official public records, documents central to plaintiff's claim, and documents sufficiently referred to in the complaint so long as the authenticity of these documents is not disputed." *Witthohn v. Fed. Ins. Co.*, 164 F. App'x 395, 396 (4th Cir. 2006) (unpublished). Courts also may take "judicial notice of the content of relevant SEC filings and other publicly available documents." *Yates v. Mun. Mortg. & Equity, LLC*, 744 F.3d 874, 881 (4th Cir. 2014). These publicly available documents can include newspaper articles, press releases, transcripts from conference calls, analysts' reports, and stock prices. *See. e.g.*, *Johnson v. Pozen Inc.*, 2009 WL 426235, at *1-2 (M.D.N.C. Feb. 19, 2009); *see also Greenhouse v. MCG Capital Corp.*, 392 F.3d 650, 655 n.4 (4th Cir. 2004). All exhibits referred to in this Memorandum are exhibits to the Declaration of Lyle Roberts in support of the Motion to Dismiss.

increase in the Company's gross margins from 35.3% to 41.1%.[3] Compl. ¶ 53; (2013 Form 10-K at 28, Ex. 3.) These changes included a series of "sourcing initiatives" designed to reduce the cost of its products. Compl. ¶ 47. The sourcing initiatives covered three primary areas: (1) volume-based discounts and cost sharing with the Company's suppliers in areas such as marketing, product samples, and new store openings; (2) engaging with mills in competitive line reviews of specific merchandise categories to evaluate product assortment, quality, logistics, and cost; and (3) direct sourcing from mills to better control product cost and quality, enhance forecasting, and broaden product assortment.[4] Compl. ¶ 215.

Although the sourcing initiatives and related decline in product costs were an important part of the gross margins increase, they were not the only factor. (2013 Form 10-K at 28-29, Ex. 3.) Of the 6.1 percentage point increase in gross margin between 2011 and 2013, only 1.5 to 2 percentage points were attributable to the sourcing initiatives. (CSFB presentation at 20, 24, attached to December 9, 2013 Form 8-K, Ex. 4.) Most of the increase – 2.5 to 4 percentage points – was attributable to changes in the Company's overall sales mix, including an increase in the average selling price for its products.[5] (*Id.*)

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[3] Gross margin is a "company's total sales revenue minus its cost of goods sold, divided by the total sales revenue, expressed as a percentage. The gross margin represents the percent of total sales revenue that the company retains after incurring the direct costs associated with producing the goods and services sold by a company." Investopedia, "Gross Margin," http://www.investopedia.com /terms/g/grossmargin.asp (last visited May 29, 2015).

[4] As part of the implementation of these initiatives, in September 2011, the Company acquired certain assets of Sequoia Floorings ("Sequoia") in China. Compl. ¶ 49. Whereas Lumber Liquidators previously had used Sequoia to provide sourcing services for most of its purchases from China suppliers, the Company was now able to have a direct relationship with these suppliers. *Id.* ¶ 49-50. In addition, it reduced its costs by no longer having to pay Sequoia to act as a middleman in the purchasing process. *Id.* ¶ 217 (cost of product declined, in part, due to "net cost reduction of owning those [Sequoia] services").

[5] Lumber Liquidators competes against both local flooring retailers and national home improvement warehouse chains (*e.g.*, Home Depot and Lowe's) in selling hardwood flooring to consumers. Compl. ¶ 53. Home Depot and Lowe's, however, also sell a vast array of other products, including building materials, home improvement products, paint, lawn and garden items, and related services. (The Home Depot 2014 Form 10-K at 1, Ex. 5; Lowe's 2014 Form 10-K at 5, Ex. 6.) Indeed, Lumber Liquidators estimates that its "product categories represent less than 2% of sales at an average Home Depot or Lowe's store." (2014 Form 10-K at 7, Ex. 1.) When Home Depot or Lowe's provides investors with its gross margins, those gross margins reflect the product costs and sales revenues for *all* of the products sold by those companies, not just hardwood flooring. Compl. ¶¶ 46, 53.

The Regulatory Environment for Wood Products – As an importer and seller of hardwood flooring, Lumber Liquidators is subject to numerous environmental regulations. These environmental regulations include: (a) the Lacey Act, 16 U.S.C. §§ 3371-3378, which bans the import and trade of illegally sourced wood products (including wood products sourced in violation of foreign laws), and (b) regulations related to formaldehyde emissions from wood products as established by the California Air Resources Board ("CARB"), Cal. Code. Regs., Tit. 17, § 93120, *et seq.*; Compl. ¶¶ 69-73, 85-90.

The Lacey Act requires importers of wood products to exercise "due care" in identifying illegally harvested wood, and companies found to have imported such wood can be subject to civil or criminal sanctions. Compl. ¶ 72. The Lacey Act does not itself, however, ban the importation of wood products from any particular geographic area. The relevant issue is whether the taking of the particular wood products at issue was illegal under the laws of the country where they were harvested, not whether the harvesting had an environmental impact.

CARB's Composite Wood Products Airborne Toxic Control Measure ("ATCM") sets limits on how much formaldehyde may be emitted from composite wood raw material products sold in the state of California. Compl. ¶¶ 86-87. CARB requires *manufacturers of composite wood products*, not retailers like Lumber Liquidators, to "conduct emission testing of their products . . . to verify that the composite wood products produced comply with the [applicable] emission standards . . . ." CARB ATCM Frequently Asked Questions at 6, Ex. 7, *available at* http://www.arb.ca.gov/toxics/compwood/implementation/faq.htm (last accessed May 30, 2015). To satisfy these requirements, CARB requires the manufacturers to ensure that those products emit no more than 0.05 ppm of formaldehyde under one of two tests: a test using a "desiccator" or a test using a "small chamber." *Id.* at 7-8. CARB's enforcement staff uses a different test – "deconstructive testing" – to test finished goods in CARB laboratories for compliance with applicable emission standards, *id.* at 6, but manufacturers, fabricators, and retailers are *not* required to engage in such finished goods testing. *Id.*

Lumber Liquidators has publicly recognized the need to work with its suppliers to comply with these environmental regulations. Compl. ¶¶ 171, 271, 221, 316. As a part of these efforts, the Company has instituted compliance processes that are performed and monitored by approximately 60 professionals around the world, including in China. *Id.* ¶¶ 58, 240, 247. The Company also has gone beyond its obligations under the ATCM by augmenting its on-site compliance efforts with additional testing in its own labs and in independent certified facilities. *Id.* ¶¶ 58, 240.

Both Lacey Act and CARB compliance, however, cannot be achieved without the cooperation of a company's suppliers. It is the suppliers who control both the purchases of raw wood and the manufacturing process that uses resins containing formaldehyde. As a result, Lumber Liquidators has consistently warned investors that "while our suppliers agree to operate in compliance with applicable laws and regulations, including those relating to environmental and labor practices, we do not control our suppliers. Accordingly, we cannot guarantee that they comply with such laws and regulations or operate in a legal, ethical, and responsible manner." (2011 Form 10-K at 13, Ex. 8; 2012 Form 10-K at 13, Ex. 9; 2013 Form 10-K at 13, Ex. 3; 2014 Form 10-K at 14, Ex. 1.) If the Company's suppliers were to violate applicable environmental laws, such conduct could "reduce demand for our products if, as a result of such violation or failure, we were to attract negative publicity" or be "expose[d] . . .to legal risks as a result of our purchase of product from non-compliant suppliers." (2011 Form 10-K at 13, Ex. 8; 2012 Form 10-K at 13, Ex. 9.)

The Zhou Post – On June 20, 2013, Xuhua Zhou wrote a post on the SeekingAlpha.com website about Lumber Liquidators' CARB compliance (the "Zhou Post"). Compl. ¶¶ 126-27. Seeking Alpha is an investment website that accepts posts from public "contributors," who are then paid, in part, based on how many people choose to view the posts. (*See* Seeking Alpha, "Article Submission Guidelines," Ex. 10, *available at* http://seekingalpha.com/page/article-submission-guidelines (last visited May 30, 2015). As disclosed by Seeking Alpha, Zhou held a short position in Lumber Liquidators' stock – *i.e.*, he stood to make money if the Company's stock price declined. (Zhou Post at 1, Ex. 11.) Zhou allegedly engaged independent labs to test samples of two of Lumber Liquidators' wood products for formaldehyde emissions using deconstructive testing. He reported that one of the two samples emitted formaldehyde at a level that exceeded CARB limits. (*Id.* at 6-7); Compl. ¶¶ 127-29.

Execution of Federal Search Warrant – On September 26, 2013, federal agents executed search warrants at Lumber Liquidators' Virginia corporate offices related to the importation of certain wood products. Compl. ¶ 19. According to a subsequent *Wall Street Journal* article (Ex. 12), the search warrants were prompted by the government's receipt of an advance copy of a report by an environmental group called the Environmental Investigation Agency ("EIA") that discussed Lumber Liquidators (the "EIA Report"). Compl. ¶¶ 17-18.

The EIA Report – The EIA Report, which was issued to the public on October 11, 2013, concerns hardwood logging in the Russian Far East ("RFE"). (*See* EIA Report, Ex. 13.) Logging in the RFE is permissible if done pursuant to valid permits, but the World Wildlife Fund has concluded that "at least 50% of the oak exported in 2010 was illegally harvested." (*Id.* at 7.) The EIA investigated the trade in RFE hardwoods and alleged that one of the major purchasers of illegal RFE oak is a wood-flooring company called Suifenhe Xingjia Economic and Trade Company ("Xingjia"). (*Id.* at 6.) According to the report, Xingjia told EIA that it illegally cuts outside of its concession boundaries, overcuts within those boundaries, and purchases over 90% of its stock from RFE trading companies that do not provide the required proof of legality of sourcing. Compl. ¶ 97; (EIA Report at 5, Ex.13.) An affiliate of Xingjia was one of Lumber Liquidators' suppliers of wood products. While the EIA Report criticized Lumber Liquidators' business relationship with Xingjia, it did *not* allege that (a) any actual wood purchased by Lumber Liquidators was illegally harvested, or (b) Lumber Liquidators knew about any harvesting issues with Xingjia's oak products. Indeed, the EIA merely concluded, based on pure speculation, that Lumber Liquidators "would have learned of the known high risk of illegally sourced timber in the RFE and known illegal actions of Xingjia and its suppliers" if it had "asked appropriate questions." (*Id*. at 21.)

The Tilson Presentation – On November 22, 2013, a hedge fund manager named

Whitney Tilson, who held a short position in Lumber Liquidators' stock, gave a presentation opining that the stock was overvalued (the "Tilson Presentation"). (Tilson Presentation at 18-19, Ex. 14.) The presentation was predicated entirely on existing public information about Lumber Liquidators, including the Zhou Post, the EIA report, and the Company's financial disclosures. Tilson concluded that "any disruption to Lumber Liquidator's supply chain and/or margins could result in the stock being cut in half." (*Id.* at 19.)

2Q 2014 Earnings Announcement – On July 9, 2014, the Company updated its second quarter earnings forecast. The Company announced that its gross margin in the second quarter of 2014 was expected to contract in comparison to the second quarter of 2013, and reported second quarter sales of $263.1 million, compared with analysts' projections of $303.2 million. Compl. ¶ 359. The Company attributed the majority of the less than 1% decline in gross margin to "adverse net shifts in sales mix and greater discounting at the point of sale." (Press Release attached to July 9, 2014 Form 8-K at 1, Ex. 15.) The remainder – at most $18 million of the sales shortfall – resulted from inventory constraints caused by the Company's implementation of enhanced "supply controls" and "quality assurance requirements." Compl. ¶ 361. As Plaintiffs concede, this decrease in sales reflected the Company's further enhancement of its internal compliance program in 2014. *See, e.g.*, *id.* ¶ 296 (noting Company's heightened "quality assurance requirements").

Proposition 65 Lawsuit – On July 23, 2014, Global Community Monitor ("GCM") and Sunshine Park LLC[6] filed a lawsuit against the Company in California state court. *Id.* ¶ 133. The Complaint alleges that the Company violated Proposition 65 – which requires businesses to notify Californians about significant amounts of chemicals in their products – by failing to warn consumers in California that certain of the Company's products emit formaldehyde in excess of the applicable safe harbor limits. *Id.* ¶¶ 132-34. GCM conducted its own deconstructive tests on

[6] The plaintiffs in the Proposition 65 suit "are backed by short sellers." *See* Ex. 16, *available at* http://www.cbsnews.com/news/lumber-liquidators-linked-to-health-and-safety-violations/ (last accessed May 27, 2015).

certain of the Company's Chinese-made laminate flooring products and allegedly found that they violated CARB limits.[7]

February 25, 2015 Earnings Call – On February 25, 2015, the Company held a conference call with analysts to discuss the Company's results for 2014. The Company stated that the DOJ might file criminal charges stemming from its 2013 Lacey Act investigation, and that it believed the news program, *60 Minutes*, would feature Lumber Liquidators in an "unfavorable light with regard to [its] sourcing and product quality, specifically related to laminates." Compl. ¶ 365.

***60 Minutes* Report –** On March 1, 2015, the CBS News television program *60 Minutes* aired a news report entitled "Lumber Liquidators" on the levels of formaldehyde in the Company's Chinese-made laminate flooring products. Tilson brought the story to *60 Minutes* after he "established [his] full (~3%) short position" in the Company.[8] *60 Minutes* reported that 30 of 31 samples it tested (using the deconstructive method) exceeded the formaldehyde emission limits set by CARB. Compl. ¶¶ 138-39. These findings were the only lab results reported by *60 Minutes* with respect to CARB compliance. *Id.* Using a separate "surface testing" method, *60 Minutes* found that only one of the three samples tested "emitted a concentration of formaldehyde . . . that the US EPA . . . has cited as 'polluted indoor conditions.'" Compl. ¶¶ 140-41; Ex. 19, http://www.cbsnews.com/news/more-on-tests-used-to-investigate-lumber-liquidators (last accessed June 1, 2015); (*see also* Piper Jaffray, April 13, 2015 at 2-3, Ex. 25.). In addition, *60 Minutes* reported that employees at three mills used by Lumber Liquidators claimed to have used cheaper "core boards with higher levels of formaldehyde" in Lumber Liquidators products, falsely labeled Lumber Liquidators products as CARB-compliant, and charged the Company 10-15% less on price. Compl. ¶¶ 144-45.

[7] *See* GCM March 2, 2015 Press Release, Ex. 17, *available at* http://www.gcmonitor.org/press-release-all-chinese%E2%80%90made-laminates-purchased-for-testing-failed-carb-standards/ (last accessed May 27, 2015).

[8] *See* Ex. 18, *available at* http://seekingalpha.com/article/2972606-why-lumber-liquidators-wood-testing-doesnt-comply-with-carb (last accessed May 27, 2015).

The Company's Response to the *60 Minutes* Report – On March 2, 2015, the Company responded to the allegations in the *60 Minutes* piece in a Form 8-K. *Id.* ¶ 149. The Company reaffirmed its belief in the safety of its products and stated "that *60 Minutes* used an improper test method in its reporting that is not included in CARB's regulations and does not measure a product according to how it is actually used by consumers." *Id.* ¶ 149. In a subsequent presentation on March 12, 2015, the Company detailed its extensive CARB compliance program, which includes a full-time compliance team on the ground in China that has steadily grown in size since 2011. (Presentation attached to the Company's March 12, 2015 Form 8-K at 18, 28, 31, Ex. 2.) The Company also requires all of its suppliers to be CARB-certified, or to source from certified manufacturers; regularly confirms core manufacturer-certification on the CARB website; conducts "announced and unannounced visits to [its] suppliers to conduct inspections and select samples" for testing; reviews supplier documentation quarterly; tests composite wood cores according to CARB testing procedures; and tests "finished goods as sold in the store . . . using standard ASTM small chamber test methods . . . ." *Id.* at 28, 31.

In March 2015, the Company initiated a program that provided at-home air testing kits to consumers. (May 7, 2015 Press Release on Laminate Flooring Sourced from China at 1, Ex. 20.) Preliminary results of these indoor air quality tests released on May 7, 2015 "indicate that over 97% of customers' homes were within the protective guidelines established by the World Health Organization for formaldehyde levels in indoor air." *Id.* The Company also established a Special Committee of the Board to review the certification and labeling processes of its Chinese suppliers. *Id.* at 2. Finally, in May 2015, despite the Company's continued belief in the safety of its products and the positive results from its air testing program, the Company suspended its sales of Chinese laminate products pending completion of the Committee's review. *Id.*

ARGUMENT

I. The Pleading Standards for Securities Fraud are Unusually Strict

Plaintiffs' principal claim arises under Section 10(b) of the Securities Exchange Act, 15

U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (a "Rule 10b-5 claim"). *See* Compl. ¶ 162. To successfully state a Rule 10b-5 claim, a plaintiff must establish: "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 157 (2008).

It is not enough, however, for a plaintiff to engage in notice pleading. A federal securities fraud claim is subject to various heightened pleading standards. A plaintiff must satisfy Federal Rule of Civil Procedure 9(b), which requires fraud claims to be pled "with particularity." The particularity requirement means that a plaintiff must plead "the time, place, and contents of the false representations, as well as the identity of the person making the misrepresentation and what he obtained thereby." *In re Mut. Funds Inv. Litig.*, 566 F.3d 111, 120 (4th Cir. 2009) (internal quotation marks omitted), *rev'd on other grounds sub nom. Janus Capital Grp., Inc. v. First Derivative Traders,* 131 S. Ct. 2296 (2011).

In addition, Congress enacted the PSLRA with the specific objective of discouraging "speculative lawsuits." *In re Cable & Wireless, PLC,* 321 F. Supp. 2d 749, 761 (E.D. Va. 2004). To that end, the PSLRA reaffirms and augments Fed. R. Civ. P. 9(b) by requiring a plaintiff to "specify each statement alleged to have been misleading, the reason or reasons why the statement is misleading, and, if an allegation regarding the statement or omission is made on information and belief, . . . [to] state with particularity all facts upon which that belief is formed." 15 U.S.C. § 78u-4(b)(1).

The PSLRA also requires that a plaintiff must, "with respect to each act or omission alleged to violate [the securities laws], state with particularity facts giving rise to a *strong inference* that the defendant acted with the required state of mind" – *i.e.,* scienter. 15 U.S.C. § 78u-4(b)(2)(A) (emphasis added). To meet this requirement, "a plaintiff must allege that the defendant made the misleading statement or omission intentionally or with 'severe recklessness' regarding the danger of deceiving the plaintiff."[9] *Teachers' Ret. Sys. of La. v. Hunter,* 477 F.3d 162, 184 (4th Cir. 2007). "A plaintiff must allege facts that support a 'strong inference' that *each* defendant acted with at least recklessness in making [each] false statement." *Id.* (emphasis in original).

"'An inference of scienter can only be strong . . . when it is weighed against the opposing inferences that may be drawn from the facts in their entirety.'" *Yates,* 744 F.3d at 885 (internal punctuation omitted). Thus, evaluating whether a strong inference of scienter has been pled "necessarily [entails] a comparative inquiry." *Id.* "'The question is whether the allegations in the complaint, viewed in their totality and in light of all the evidence in the record, allow [the court] to draw a strong inference, at least as compelling as any opposing inference,'" that a defendant acted knowingly or with severe recklessness. *Id.* "When the facts as a whole more plausibly suggest that the defendant acted innocently – or even negligently – rather than with intent or severe recklessness, the action must be dismissed." *Cozzarelli v. Inspire Pharm. Inc.*, 549 F.3d 618, 624 (4th Cir. 2008).

Complaints that fail to meet these heightened pleading standards *must* be dismissed. *See* 15 U.S.C. § 78u-4(b)(3)(A). Here, Plaintiffs fail to adequately plead the existence of scienter, falsity, and loss causation.

II. Plaintiffs Do Not and Cannot Plead a Strong Inference that Any of the Defendants Acted with Scienter

The Complaint's factual allegations fail to establish the required "strong inference" that any of the Defendants acted with scienter.[10] The Complaint identifies no document, witness, or

[9] "In the § 10(b) context, a reckless act is one that is 'so highly unreasonable and such an extreme departure from the standard of ordinary care as to present a danger of misleading the plaintiff to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Yates*, 744 F.3d at 884.

[10] For a corporation to have acted with the requisite scienter, at least one of its agents that made the false or misleading statement must have acted with scienter. *See Teachers' Ret.*, 477 F.3d at 184 (strong inference of scienter required for "at least one authorized agent of the corporation"); *In re Computer Sciences Corp. Sec. Litig.*, 890 F. Supp. 2d 650, 664-65 (E.D. Va. 2012) (rejecting argument that scienter of corporate agents who did not make statements in question could be imputed to corporation).

other piece of evidence establishing that any Individual Defendant – or anyone else at the Company – knew or was severely reckless in not knowing of the supposed regulatory violations and their alleged impact on Lumber Liquidators' financial performance. Indeed, the most compelling inference to be drawn from a holistic analysis of all of the facts properly before this Court is that, even if regulatory violations occurred, Defendants acted appropriately in making the Company's public disclosures.

A. Plaintiffs Offer No Allegations Establishing a Strong Inference that Defendants Were Aware of Any CARB Violations

Plaintiffs allege that "the Company sourced laminate and engineered flooring products that contained and emitted dangerously high levels of formaldehyde and that failed to comply with applicable laws and regulations governing formaldehyde emissions under CARB standards." Compl. ¶ 13. Even if Plaintiffs are ultimately able to demonstrate that this took place (in unspecified quantities and at unspecified times), they have failed to adequately allege, as to each Defendant, that the Defendant knew (or was severely reckless in not knowing) (a) about the importation of laminate products with high levels of formaldehyde, *and* (b) that those formaldehyde levels did not comply with applicable laws and regulations governing formaldehyde emissions, *and* (c) that the Company's statements regarding compliance with those laws and regulations were false or misleading. Indeed, rather than offer any *specific* factual allegations demonstrating *individualized* knowledge or severe recklessness, Plaintiffs make *general* allegations that courts have routinely rejected as insufficient to meet the "strong inference" standard.

First, Plaintiffs assert that outside third parties have "easily determined that Lumber Liquidators' Chinese-made laminates and engineered flooring products contained and emitted high levels of formaldehyde." Compl. ¶ 336. Contrary to the repeated assertions in the Complaint, however, it is unclear that Lumber Liquidators has sold *any* products that contain an inappropriately high level of formaldehyde. There is an ongoing scientific dispute about how to test the formaldehyde emissions from laminate flooring that is not resolved by any applicable

CARB guidance. The Company has consistently taken the position, based on its own testing, that its laminate flooring products are compliant with CARB standards.

Notably missing from the Complaint are any factual allegations suggesting that Lumber Liquidators' reliance on its own testing (which the Company was not even required to conduct) was unreasonable. The Zhou Post, the Global Community case, and the *60 Minutes* report all use deconstructive testing, which takes apart the finished product and tests the core (which is the only component regulation by CARB's emissions standards). (Script for Business Update Conference Call attached to the Company's March 12, 2015 Form 8-K at 13, Ex. 21.) CARB's enforcement staff also uses deconstructive testing to test finished goods, but CARB provides no standards for evaluating the results. *See* CARB ATCM Frequently Asked Questions at 6, Ex. 7. Moreover, it is indisputable that deconstructive testing does not measure a product the way it is used in a home. Removing the outer protective layers, along with the adhesive glues and resins, exposes the less dense fiberboard that was previously sealed and protected by higher density barriers. (Ex. 21, March 12, 2015 Form 8-K at 13.) This process "promotes formaldehyde release because the higher density areas, which act as barriers, have been stripped away." *Id.* [11]

Accordingly, outside groups, including most notably the Consumer Product Safety Commission (CPSC), have apparently agreed with Lumber Liquidators that the use of a "deconstruction test" – *i.e.*, the test used by all of the individuals and entities who have claimed that the Company is not in compliance with CARB – is inappropriate to evaluate emissions for a consumer. [12] The existence of a scientific disagreement over testing procedures, by itself,

[11] CARB recognizes that "[v]arious studies have shown that laminated flooring . . . [with] sealed surfaces and edges reduce the emissions from the platform materials." CARB Fact Sheet, Ex. 22, *available at* http://www.arb.ca.gov/html/fact_sheets/composite_wood_flooring_faq.pdf (last accessed May 27, 2015).

[12] When the CPSC announced that it was launching an investigation into Lumber Liquidators laminate products, it stated that the Commission would not utilize deconstructive testing. Rather, it would rely on "a method that most closely replicates the way that the products are used in the home." Transcript of CPSC Media Call on Lumber Liquidators at 8, Ex. 23, *available at* http://www.cpsc.gov/Global/Newsroom/CPSCPressCall03262015_FINAL.pdf (last accessed May 27, 2015). *See also* Federal Wood Industries Coalition Statement on Deconstructive Testing, Ex. 24, ("[Deconstructive testing] is not required by CARB to demonstrate compliance[,] . . . nor has it been adopted by ASTM or other consensus standards bodies. The

obviously cannot form any inference of scienter. *See In re Vertex Pharm. Inc., Sec. Litig.*, 357 F. Supp. 2d 343, 355 (D. Mass. 2005) ("existence of scientific disagreement" as to potential viability of drug cannot provide necessary inference of scienter).[13]

Nor have Plaintiffs provided any basis for questioning that Defendants believed Lumber Liquidators was in compliance with the CARB standards. Plaintiffs interviewed a series of former Lumber Liquidators employees who allegedly worked in senior positions at the Company and are familiar with its China operations. Compl. ¶¶ 60-68. But *none* of these former employees claimed, even anonymously, that Lumber Liquidators knew about CARB violations or even that the Company had any deficiencies in its regulatory compliance program. *See, e.g., In re ECI Telecom Ltd. Sec. Litig.*, CV No. 01-913-A, slip op. at 7 (E.D. Va. Nov. 21, 2001), Ex. 26 ("Because plaintiffs clearly have obtained the cooperation of former [defendant] employees, this Court expects that plaintiffs should be able to articulate these claims with the requisite specificity."); *City of Royal Oak Ret. Sys. v. Juniper Networks, Inc.*, 880 F. Supp. 2d 1045, 1064 (N.D. Cal. 2012) (dismissing complaint where plaintiffs "fail[ed] to allege facts that provide an analytical link between the particular facts supplied by the confidential witness and the ultimate conclusion that Juniper could not meet its overall revenue and growth goals"). These "omissions" cut strongly against any inference of scienter.[14]

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deconstructive method . . . can fundamentally change the emission properties of the panel substrate."), a*vailable at* http://www.iwpawood.org/news/221058/IWPA-Joins-Industry-Associations-in-Statement-on-Deconstructive-Testing-for-Formaldehyde-Emiissions.htm (last accessed May 27, 2015).

[13] *See also In re Biogen Sec. Litig.*, 179 F.R.D. 25, 38 (D. Mass. 1997) ("split of expert opinion" cannot support either fraudulent intent or recklessness); *In re Medimmune, Inc. Sec. Litig.*, 873 F. Supp. 953, 966-67 (D. Md. 1995) ("Medical researchers may well differ over the adequacy of given testing procedures and in the interpretation of test results. Although the Advisory Committee may have disagreed, there is nothing to suggest that Defendants could not reasonably have entertained the opinion, for example, that the concentration of test results at the Denver site was a function of either or both the altitude or the higher proportion of bronchopulmonary dysplasia patients at that site."). The fact that *60 Minutes* also applied a test that used a "surface" method is irrelevant. Compl. ¶¶ 140-141. The Complaint conveniently omits the fact that, under that testing methodology, only one of three Lumber Liquidators samples emitted a high level of formaldehyde. (*Id.; see also* http://www.cbsnews.com/news/more-on-tests-used-to-investigate-lumber-liquidators, Ex. 19; Piper Jaffray, April 13, 2015 at 2-3, Ex. 25.)

[14] The only confidential witness who supplies any statements concerning Lacey Act or CARB compliance is CW6, but the statements attributed to him are both unreliable and inadequate.

Second, Plaintiffs argue that Defendants knew that the laminate flooring was non-CARB compliant based on their positions at the Company and the fact that they are in the business of selling wood flooring. In particular, Plaintiffs assert (a) the Individual Defendants oversaw "Lumber Liquidators' sourcing practices in China," Compl. ¶¶ 340-41, and (b) laminate flooring was a "core operation" of the Company. Compl. ¶¶ 346-47.

As a threshold matter, general assertions that defendants must have acted intentionally or recklessly because they were executives or the relevant product was important to the company must be rejected. *Yates*, 744 F.3d at 890 ("[I]n accordance with several of our sister circuits, we reject plaintiffs' contention that the individual defendants must have acted intentionally or recklessly . . . merely because (1) they were senior executives, and (2) [the operations at issue] represent a core business of the Company."). Without "additional detailed allegations establishing the defendants' actual exposure to the . . . problem," these "must have known" allegations cannot create a strong inference of scienter. *Id.*

Moreover, Plaintiffs' allegations concerning the Individual Defendants' roles at the Company and the "core" nature of laminate flooring are deficient on their face. While some of the Individual Defendants participated in the Company's sourcing initiatives, Compl. ¶¶ 340-41, there are no allegations that they personally were involved with CARB compliance or ever received any information concerning CARB compliance. Plaintiffs' suggestion that because Mr. Lynch and Mr. Schlegel visited some of the Chinese mills they must have known about CARB

Compl. ¶¶ 60(f), 67-68. *First*, CW6 is described as working in inbound sales, commercial sales, marketing, and special events, *not* in compliance or as a products buyer. Compl. ¶ 60(f). Accordingly, there is no reason to believe that CW6 had any first-hand knowledge of regulatory compliance issues. *Teacher's Ret.*, 477 F.3d at 174 ("When the complaint chooses to rely on facts provided by confidential sources, it must describe the sources 'with sufficient particularity to support the probability that a person in the position occupied by the source would possess the information alleged or in the alternative provide other evidence to support their allegations.'"). *Second*, CW6's supposed statements – *e.g.*, "With regard to laminates and formaldehyde content, CW6 said that 'there may have been some wrong doing on our part.'" (Compl. ¶ 68) – do not provide any *facts* that could be used to create an inference of scienter, even if some unspecified "wrong doing" had occurred. *In re Trex Co., Inc. Sec. Litig.*, 454 F. Supp. 2d 560, 573 (W.D. Va. 2006) (CW statements were "based on speculation and opinion and do not provide the information and belief necessary to support pleadings under the PSLRA.").

compliance issues is spurious. Nowhere do Plaintiffs allege that the Individual Defendants were given tours of any of the supposedly non-CARB compliant mills or that they were informed of any CARB compliance issues. *See, e.g., In re Winn-Dixie Stores, Inc. Sec. Litig.,* 531 F. Supp. 2d 1334, 1350 (M.D. Fla. 2007) ("'[I]t is not enough to make conclusory allegations that Defendants had access to the 'true facts' in order to demonstrate scienter, particularly when the complaint fails to allege which defendant knew what, how they knew it, or when."). Laminate flooring also was *not* a "core operation" of Lumber Liquidators. A "core operation" is something that constitutes "nearly all of a company's business." *Tyler v. Liz Claiborne, Inc.*, 814 F. Supp. 2d 323, 343-44 (S.D.N.Y. 2011) (rejecting allegation that business constituting 16% of sales was "core" business). A product that constitutes only 23% of a company's net sales – as laminates allegedly did for Lumber Liquidators in 2011 (Compl. ¶ 347) – obviously does not meet that definition.

Finally, Plaintiffs appear to allege that Defendants disregarded supposed "red flags" such as "absurdly low prices" for laminates, Compl. ¶¶ 342-43, a supposedly inadequate compliance program, *id.* ¶¶ 344-45, and a handful of anonymous customer complaints on the Company's website. *Id.* ¶¶ 348-51. While circumstantial evidence of corporate problems can contribute to an inference of scienter, that is only true if the "red flags . . . would have revealed the errors prior to their inclusion in public statements." *Ottman v. Hanger Orthopedic Grp., Inc.*, 353 F.3d 338, 351 (4th Cir. 2003) (quoting *Hoffman v. Comshare, Inc.*, 183 F.3d 542, 554 (6th Cir. 1999)).

Plaintiffs offer very little in the way of factual predicate for the existence of these "red flags." The entire basis for the assertion that Lumber Liquidators saved money by purchasing non-CARB compliant laminate flooring is supposed statements by unknown Chinese mill employees that "they are capable of manufacturing CARB compliant flooring, but it would cost 10-15% more." Compl. ¶ 343. These allegations must be steeply discounted because Plaintiffs do not explain who these employees are, what position they held at the mills, or why they would be in a position to speak reliably about Lumber Liquidators' purchases. *Teachers' Ret.*, 477 F.3d at 174 (plaintiffs must establish reliability of confidential witness statements).[15] As for the Company's compliance program, Plaintiffs rely entirely on a supposed public admission that "Lumber Liquidators did not begin building a compliance team in China until December of 2014." Compl. ¶ 344. In fact, the cited article merely includes a quote from Lumber Liquidators' head of compliance to the effect that he is having "a compliance team being built in China as we speak," with no specificity as to what that particular team would cover. *Id.* In numerous other public statements, the Company has made it clear that it had compliance personnel in China throughout this period. (*See, e.g.*, Business Update Presentation attached to March 12, 2015 Form 8-K, at 18, Ex. 2) Meanwhile, the customer complaints consist of exactly four complaints made over the course of four years (2010 – 2014), for a product that Plaintiffs elsewhere allege has been installed in "hundreds of thousands" homes. Compl. ¶ 136.

Whether viewed individually or collectively, these supposed "red flags" cannot establish a strong inference of scienter. Nothing about a modest price savings (10-15% is hardly "absurd" under any circumstances), the Company's continued efforts to expand its compliance team in China, or a handful of customer complaints would have put the Individual Defendants on notice of widespread formaldehyde emissions problems. In the absence of any red flags that actually revealed these problems – to the extent that they existed at all – Plaintiffs' scienter pleading burden has not been met. *See, e.g.*, *Brophy v. Jiangbo Pharm., Inc.*, 781 F.3d 1296, 1304 (11th Cir. 2015) (red flag allegations insufficient to establish inference of scienter because "complaint provides no explanation as to how these red flags should have alerted [the defendant] to the fraud").

B. Plaintiffs Offer No Allegations Establishing a Strong Inference that Defendants Were Aware of Any Lacey Act Violations

Plaintiffs face a formidable burden in pleading that Defendants knew, or were severely

[15] Plaintiffs also cite Whitney Tilson for the proposition that Lumber Liquidators was receiving a 10% discount on non-CARB compliant laminate flooring, but Mr. Tilson would have no independent basis for this knowledge and appears merely to be repeating what was supposedly stated by the mill employees. *See, e.g.*, Compl. ¶ 148.

reckless in not knowing, that the Company purchased illegally harvested oak from the RFE. After all, neither the Complaint nor the EIA Report alleges that *Lumber Liquidators* engaged in illegal harvesting. Rather, the supposed illegal harvesting was at the beginning of the supply chain, when the oak was harvested, and therefore before the wood was bought by Xingjia, processed, and allegedly re-sold as flooring to Lumber Liquidators. *See, e.g.*, Compl. ¶ 76; (EIA Report at 6-8, Ex. 13.) The relevant issue is thus whether Defendants knew that any Russian oak the Company purchased from a supplier had been illegally harvested by *someone else*.

The Complaint contains no direct allegations concerning the Defendants' knowledge of this supposed illegal harvesting. In particular, Plaintiffs cite no confidential witness statements or company documents that would support an inference that any Individual Defendant was aware that the hardwood the Company imported from northern China had been illegally sourced in the RFE. *See, e.g.*, *ECI Telecom*, slip op. at 7, Ex. 26 ("Because plaintiffs clearly have obtained the cooperation of former [defendant] employees, this Court expects that plaintiffs should be able to articulate these claims with the requisite specificity."). Instead, Plaintiffs rely on circumstantial allegations that are clearly deficient.

First, Plaintiffs suggest that Defendants must have known that some of the wood the Company purchased was illegally harvested because the oak purchases came from the RFE. The bare fact that oak comes from the RFE, however, has no bearing on its legality. As the Complaint concedes, it is perfectly legal to harvest timber in the RFE in certain areas and subject to permits. Compl. ¶ 76. Even under the World Wildlife Fund's most recent estimate, only 50% of the oak exported from the RFE is done so illegally, which leaves another 50% that can be properly imported by a U.S. company.[16] (EIA Report at 7, Ex.13.)

[16] Plaintiffs allege that Lumber Liquidators would have learned the "truth" if it had entered certain specific terms into the Russian version of Google or called an unidentified "forest enforcement office." Compl. ¶¶ 101-02. Of course, as the Complaint implicitly concedes, such actions would not have demonstrated that any of the wood actually being purchased by Lumber Liquidators had been illegally harvested. *See, e.g.*, *In re Galileo Corp. S'holders Litig.*, 127 F. Supp. 2d 251, 265 (D. Mass. 2001) ("Because at the most the plaintiffs here have alleged only that the defendants failed to discover warning signs about Imagyn's financial condition, the plaintiffs have failed sufficiently to allege scienter in the form of reckless, as distinguished from

Second, Plaintiffs appear to suggest that the fact that certain agencies of the U.S. government executed search warrants at the Lumber Liquidators headquarters and *might* bring charges against the Company supports an inference of scienter. *See, e.g.*, Compl. ¶¶ 19, 22. The execution of search warrants or potential charges, however, only indicates that the government is investigating, and a mere investigation is "too speculative to add much, if anything, to an inference of scienter." *Cozzarelli*, 549 F.3d at 628 n.2.[17] Plaintiffs do not, because they cannot, identify any *facts* that the government has uncovered that would provide evidence of intentional wrongdoing at the Company.

Finally, Plaintiffs focus on visits by Lumber Liquidators' personnel to Xingjia facilities. *See, e.g.,* Compl. ¶¶ 104, 110. In particular, Plaintiffs allege that EIA investigators were given a tour of the Xingjia facilities during which Xingjia officials allegedly confessed to illegal conduct, and that Lumber Liquidators employees were at some point given a "similar" tour. *Id.* ¶¶105-110. But at no point do Plaintiffs allege that the Xingjia officials made the same confessions to Lumber Liquidators' employees (even though this would have been an obvious follow-up question for the EIA investigators to ask). *See, e.g.*, *Winn-Dixie*, 531 F. Supp. 2d at 1350 ("'[I]t is not enough to make conclusory allegations that Defendants had access to the 'true facts' in order to demonstrate scienter, particularly when the complaint fails to allege which defendant knew what, how they knew it, or when.'"). Indeed, Plaintiffs do not allege anything about what the Company's employees allegedly heard or saw at the Xingjia facilities.[18] *Plumbers and*

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negligent, conduct on the part of the defendants."). Plaintiffs also point to an alleged "fraudulent Lacey Act Declaration" that misidentifies the source of the wood. (*Id.* ¶ 119.) The EIA Report, however, discloses that the document was provided by Greenhome, not by Lumber Liquidators. (EIA Report at 21,22 Ex. 13.) Moreover, the declaration, which is ultimately supposed to be filled out, signed, and filed with the U.S. Department of Agriculture, *see* 16 U.S.C. § 3372(f), is unsigned. This strongly suggests that it was never filed or approved for filing, and Plaintiffs offer no allegations to suggest that Lumber Liquidators was ever made aware of this document (even in draft form).

[17] *See also In re BearingPoint, Inc. Sec. Litig.*, 525 F. Supp. 2d 759, 777 (E.D. Va. 2007) ("Inferring scienter from the mere existence of an investigation would be an end-run around the stringent pleading requirements of the PSLRA . . . ."), *rev'd and remanded on other grounds sub nom. Matrix Capital Mgmt. Fund, LP v. BearingPoint, Inc.*, 576 F.3d 172 (4th Cir. 2009).

[18] At best, Plaintiffs rely on hearsay statements from an officer at one Chinese mill. According to the Complaint, EIA asked Mr. Yu – the manager of Xingjia's Dalian facilities – directly

Pipefitters Local Union 719 Pension Fund v. Zimmer Holdings, Inc., 2011 WL 338865, at *20-21 (S.D. Ind. Jan. 28, 2011) (plaintiff's allegation that defendants' representatives may have witnessed company problems failed to support strong inference of scienter).

Moreover, the only one of the Individual Defendants alleged to have attended these site visits was Mr. Schlegel. Compl. ¶¶ 337-39. Even if this allegation could support an inference of scienter as to Mr. Schlegel, which it cannot (*see supra*), his supposed knowledge cannot be imputed to any other Defendant. The Complaint contains no allegations establishing that Mr. Schlegel communicated anything about his visits to the other Individual Defendants. In addition, Mr. Schlegel had nothing to do with the public disclosures at issue, and his mental state thus cannot be attributed to Lumber Liquidators for purposes of a Rule 10b-5 claim. *See Computer Sciences Corp.*, 890 F. Supp. 2d at 664-65 (corporation's scienter cannot be established by scienter of individuals not involved in public statements).[19]

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whether Lumber Liquidators was aware of any illegal harvesting. Compl. ¶ 108. Mr. Yu opines to EIA: "Yes, of course they know that." *Id*. Noticeably missing from Mr. Yu's comments, however, are factual allegations establishing *how and when* Lumber Liquidators supposedly obtained this knowledge, and *which* of the Individual Defendants allegedly obtained it. For example, Mr. Yu provides information about Lumber Liquidators' visits to his mill, but noticeably does not state that during those visits the Company personnel were ever told about illegal harvesting. Accordingly, Mr. Yu's *opinion* as to Lumber Liquidators' knowledge does nothing to support a strong inference of scienter. *In re Career Educ. Corp. Sec. Litig.*, 2006 WL 999988, at *6 (N.D. Ill. Mar. 28, 2006) (plaintiffs could not rely on interviews in *60 Minutes* segment because, *inter alia*, they failed to establish "that it is probable that each of the interviewees had access to or knowledge of the allegations about which they spoke").

[19] In fact, because Mr. Schlegel had no involvement with the public statements, all claims against him must be dismissed. Only the "maker" of a false or misleading statement can be held liable under Rule 10b-5 for making false statements. *Janus Capital Grp., Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2302 (2011). "For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." *Id*. Plaintiffs allege that "Defendant Schlegel was involved in drafting, reviewing, and/or disseminating the false and misleading statements that were issued by Lumber Liquidators, approved or ratified these statements," but this type of boilerplate allegation cannot save their claims. Plaintiffs do not identify any specific statements made by Mr. Schlegel, much less offer any plausible allegations that, as a Chief Merchandising Officer, he wielded "ultimate authority" over any corporate statements. Nor can Mr. Schlegel be held liable for any alleged failure to correct statements made by other corporate officers. *Oneida Sav. Bank v. Uni-Ter Underwriting Mgmt. Corp.*, 2014 WL 4678046, at *12 (N.D.N.Y. Sept. 18, 2014); *Ho v. Duoyuan Global Water, Inc.*, 887 F. Supp. 2d 547, 572 n.13 (S.D.N.Y. 2012).

C. Plaintiffs Do Not Adequately Allege that Defendants Acted with Scienter in Making Any Statements About the Company's Financial Performance

Plaintiffs' overall theory of fraud is that the Company's gross margin increases were driven by its importation of illegal and hazardous products. *See, e.g.*, Compl. ¶ 13. Having failed to establish any strong inference of scienter as to CARB and Lacey Act violations, however, Plaintiffs have obviously failed to establish that the Defendants knew the Company's financial statements were misleading as a result of those violations. Indeed, the Complaint contains no particularized facts concerning the impact of the supposed regulatory violations on the Company's gross margins (or, more broadly, its earnings and revenues), let alone that Defendants knew about this impact. The Tilson Presentation, which appears to be the sole source of the Complaint's financial assertions, also makes no reference to what any individual Defendant would have known, cites no internal sources or documents, and even disclaims its own accuracy. (*See, e.g.*, Tilson Presentation at 3, Ex. 14.) In sum, none of the allegations in the Complaint rebuts the competing inference that Defendants innocently (and correctly) attributed the Company's increased gross margins to normal business developments. *See, e.g.*, *Davis v. SPSS, Inc.*, 385 F. Supp. 2d 697, 716 (N.D. Ill. 2005) (where "complaint provides factual allegations of [] knowledge of improper practices," but does not establish "what relevance they had on [the company's] bottom line," the court cannot assume defendants knowingly misrepresented financial statements).

D. The Individual Defendants' Stock Sales Are Not Unusual or Suspicious

Specific facts demonstrating motive and opportunity may be relevant to the issue of scienter, but usually are insufficient to establish a strong inference of scienter by themselves. *In re PEC Solutions Sec. Litig.*, 2004 WL 1854202, at *13 (E.D. Va. May 25, 2004), *aff'd*, 418 F.3d 379 (4th Cir. 2005). Here, Plaintiffs' primary motive allegation is that the Individual Defendants sold their Lumber Liquidators stock during the Class Period and therefore had a "motive" to artificially inflate the stock price by making false statements. In the Fourth Circuit, however, "[i]nsider trading allegations will *only* support an inference of scienter 'if the timing *and* amount of a defendant's trading were unusual or suspicious.'" *Yates*, 744 F.3d at 890 (emphases added).

Whether the Individual Defendants' trading histories are examined individually or collectively, their trading does not meet this standard.

Mr. Sullivan – Mr. Sullivan's class period sales were anything but unusual. The fact that an insider's class period sales are consistent with a pattern predating the class period weighs against an inference of scienter. *Id.* at 891 (finding no inference of scienter when defendant's sales "occurred at fairly regular intervals and amounts compared to earlier periods"). Here, as demonstrated in the chart and Form 4s attached as Exhibits 27 and 28, Mr. Sullivan began to divest himself of his Lumber Liquidators shares in 2007, well before the start of the class period. Indeed, Mr. Sullivan sold more than *ten times as many shares* in the five-year period preceding the class period (13,183,289), as he did during the three-year class period (1,207,713). And he still held 608,998 shares at the end of the class period – more than 50% of the number of shares that he sold during the class period. Thus, when considered in context, his class period sales were not "unusual" and do not contribute to a strong inference of scienter.[20]

The timing of Mr. Sullivan's sales also shows that they were not suspicious. Courts have routinely found that even large stock sales – large in terms of total amount or as a percentage of the seller's holdings – are not suspicious when plaintiffs fail to adequately allege that the timing of the sales was "'calculated to maximize the personal benefit from undisclosed inside information.'" *Ronconi v. Larkin*, 253 F.3d 423, 435 (9th Cir. 2001); *see also Teachers' Ret.*, 477 F.3d at 184 ("[D]efendants' sales generally occurred at prices that were not especially high for the class period."). Here, the majority of Mr. Sullivan's sales were made at prices markedly below the class period high. Of the 1,207,713 shares Mr. Sullivan sold during the class period, 707,713 – *58% of his total class period sales* – were sold at less than $30 per share. *See* Chart of Insider Sales, Ex. 29. Moreover, 75% of his total sales were made at prices less than $55 per share, and *92%* of his total sales were made at prices below $85 per share. In contrast, the class

[20] *See, e.g., In re Travelzoo Inc. Sec. Litig.*, 2013 WL 1287342, at *10 (S.D.N.Y. Mar. 29, 2013) (holding that defendant's sale of 95% of her stock did not give rise to strong inference of scienter because her sale during class period "was [not] inconsistent with her prior trading practices").

period high was $119.44. As the Ninth Circuit found in *Ronconi*, "[w]hen insiders miss the boat this dramatically, their sales do not support an inference" that they are defrauding the public. 253 F.3d at 435.

Mr. Terrell – Mr. Terrell's class period sales also cannot be considered suspicious. More than 84% of Mr. Terrell's sales during the class period occurred on November 7, 2012, when the price of the Company's stock was $57.86, *less than half* of the class period high of $119.44. *See* Chart of Insider Sales, Ex. 29; *see also* Terrell Form 4s, Ex. 30. Again, sales that "miss[ed] the boat this dramatically" do not contribute to a strong inference of scienter. *Ronconi*, 253 F.3d at 435.

Mr. Lynch – Various aspects of Mr. Lynch's trading history also weigh against an inference of scienter. First, when Mr. Lynch started selling in May 2013, the Company's performance was still improving, and the stock price was still rising. Lumber Liquidators' second quarter was better than its first, and its third quarter was better than its second.[21] Second, on October 29, 2014, Mr. Lynch *purchased* 4,000 shares of the Company's stock, and shortly thereafter, on November 5, 2014, he purchased an additional 2,000 shares. Lynch Form 4s, Ex. 31. As Plaintiffs emphasize, at that time the Company was the subject of an ongoing investigation. *See, e.g.*, Compl. ¶ 19. Mr. Lynch would not have made such purchases had he believed that the investigation would reveal illicit sourcing practices.[22] *See, e.g.*, *PEC Solutions*, 2004 WL 1854202, at *16 ("Moreover, the fact that three of the four Individual Defendants acquired PEC stock during the class period[] further negates any idea that the Individual

[21] The Complaint's allegation (¶ 322) that Mr. Lynch held only 10,000 shares of unrestricted stock by the time of the government's raid on September 26, 2013 is incorrect. As Mr. Lynch's SEC filings show, he held 34,216 unrestricted shares at that time, worth approximately $3,865,039 ($112.96 per share).

[22] In addition, many of Mr. Lynch's sales were pursuant to a 10b5-1 trading plan. *See* Lynch Form 4s, Ex. 31. Such plans "allow[] corporate insiders to set a schedule by which to [automatically] sell shares" over time. *Wietschner v. Monterey Pasta Co.*, 294 F. Supp. 2d 1102, 1117 (N.D. Cal. 2003); *see also* 17 C.F.R. 240.10b5-1. Because an insider cannot control the timing of sales made pursuant to a 10b5-1 plan, Mr. Lynch's sales made under this plan could not have been "timed . . . to profit from any particular disclosure." *See, e.g.*, *Gaer v. Am. Pub. Educ., Inc.*, 895 F. Supp. 2d 763, 790-91 (N.D.W. Va. 2011).

Defendants had a motive to commit fraud.").

Mr. Schlegel – As shown previously, Mr. Schlegel did not "make" any of the alleged misstatements in the Complaint, and therefore is not subject to Rule 10b-5 liability. *See supra* at p. 21 n.19. Mr. Schlegel's sales of $1,455,452.59 of stock – a relatively modest figure in comparison to the other Individual Defendants – is therefore irrelevant in analyzing the scienter of the remaining Defendants. *See* Schlegel Form 4s, Ex. 32; *see also, e.g., In re Michaels Stores, Inc. Sec. Litig.*, 2004 WL 2851782, at *13 (N.D. Tex. Dec. 10, 2004) ("[B]ecause [certain insiders] are not specifically linked to any of the alleged misstatements or omissions, their sales are irrelevant to the scienter determination.").[23] In any event, Plaintiffs' allegation (Compl. ¶ 325) that prior to the Class Period Mr. Schlegel "had not sold a single share of stock or exercised a single option" is hardly surprising: Mr. Schlegel did not arrive at Lumber Liquidators until 2011 (*id.* ¶ 38).

Plaintiffs' insider trading allegations fare no better when the trading of the Individual Defendants is examined collectively.[24] Nearly 45% of the shares sold by the Individual Defendants were at prices *below* $50, and nearly 85% of the shares sold by Defendants were sold at prices *below* $90 – prices well below the class period high of $119.44. *See* Chart of Insider Sales, Ex. 29.[25] In sum, the most plausible inference drawn from the Individual Defendants' trading histories is the innocent inference that they sold their shares "in the normal course of events." *See In re Burlington Coat Factory Sec. Litig.*, 114 F.3d 1410, 1424 (3d Cir. 1997) ("A large number of today's corporate executives are compensated in terms of stock and stock options. It follows then that these individuals will trade those securities in the normal course of events.").[26]

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[23] For the same reasons, Plaintiffs' allegations regarding the sales of other non-defendant insiders, *see* Compl. ¶¶ 326-39, cannot support a strong inference of scienter as to the Individual Defendants.

[24] Plaintiffs also contend that the Company's insiders engaged in a "coordinated and wholesale selling of securities." *See* Compl. ¶ 330. This allegation fails to move the needle toward scienter. The Company's Insider Trading Policy establishes a trading window that opens three days after an earnings release and closes thirty days before the end of the quarter. (Lumber Liquidators Holdings, Inc. Insider Trading Policy at 3, Ex. 33, *available at* http://investors.lumberliquidators.com/corporate-governance (last visited June 1, 2015).). Both sets of supposedly "coordinated" transactions by the Company's insiders took place during these open windows, which were the only times that insiders *could have* sold. *See, e.g., In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1030 (C.D. Cal. 2003) ("The trading window . . . explains why the insider defendants had common trading days.") *vacated sub nom. on other grounds Simpson v. Homestore.com, Inc.*, 519 F.3d 1041 (9th Cir. 2008).

[25] As the Fourth Circuit has held, "a lengthy class period makes it difficult to infer intent from the mere fact of a stock sale, as it is not unusual for insiders to trade at some point during their tenure with a company." *Yates*, 744 F.3d at 891. The expansive 36-month putative class period alleged here therefore also weighs against an inference that any individual stock sale was

III. Plaintiffs Fail to Adequately Plead that Defendants Made Any False Statements

Not only have Plaintiffs failed to plead a strong inference of scienter, but they also have not pled facts demonstrating that the Company's failure to disclose the existence of supposed CARB and Lacey Act violations rendered all of its statements about regulatory compliance and financial performance false. Even assuming, *arguendo*, that Plaintiffs had adequately pled that widespread violations occurred (which they have not), the mere existence of the violations do not demonstrate falsity.[27] *Longman v. Food Lion, Inc.*, 197 F.3d 675, 682 (4th Cir. 1999) (plaintiffs must adequately plead that omitted information rendered statements misleading).

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suspicious. *See, e.g.*, *id.* ("An additional problem with the allegations of insider trading relates to the length of the putative class period. The plaintiffs have chosen an inordinately long period of 44 months."); *Teachers' Ret.*, 477 F.3d at 185 (characterizing class period of 46 months as "exceedingly long").

[26] Plaintiffs attempt to bolster their motive allegations by claiming that the incentive compensation paid to Mr. Lynch and Mr. Schlegel was tied to the Company's gross margin. Compl. ¶¶ 331-34. However, courts have recognized that allegations that the individual defendants failed to disclose information based on their desire to increase their executive compensation are insufficient to support a strong inference of scienter. *See, e.g., Iron Workers Local 16 Pension Fund v. Hilb Rogal & Hobbs Co.*, 432 F. Supp. 2d 571, 591 (E.D. Va. 2006) ("Allowing a party to plead scienter by alleging executives were motivated by a financial incentive program would effectively eliminate the state of mind requirement as to all corporate officers . . . . [T]his generalized motive, shared by most, if not all, corporate officers, is insufficient to plead scienter." (internal citations and quotation marks omitted)).

[27] Moreover, noticeably absent from the Complaint are any allegations that Mr. Sullivan, as the Chairman of the Company, took actions in furtherance of the alleged fraud (other than the signing of the Company's annual reports). Under the PSLRA, courts in this Circuit have rejected the use of group pleading, under which "corporate officers and directors who are alleged to be in day-to-day control of the company may be presumed to be collectively responsible for a company's 'group published' information such as prospectuses, registration statements, annual reports, press releases and other public filings." *In re Royal Ahold N.V. Sec. & ERISA Litig.*, 351 F. Supp. 2d at 369-70; *see also In re Constellation Inc. Sec. Litig.* 738 F. Supp. 2d 614, 635 n.20 (D. Md. 2010). Inasmuch as Mr. Sullivan did not sign any documents other than the Company's annual reports, *see* Compl. ¶¶ 165, 211, 259, 306, he cannot be held liable for any of the other allegedly false statements.

A. Alleged False Statements Regarding Regulatory Compliance

Plaintiffs allege that Lumber Liquidators' statements concerning its regulatory compliance were false. *See, e.g.*, Compl. ¶¶ 240, 269, 271, 318. These statements, however, generally fall into two categories: (a) statements of *fact* concerning the Company's compliance policies, personnel, and activities (*e.g.*, *id.* ¶ 247 ("The Company has more than 60 professionals around the world who perform and monitor those processes . . . .")), and (b) statements of *opinion* that the Company has a strong quality control and assurance program and conducts its activities in compliance with the law (*e.g.*, *id.* ¶ 271 ("We believe that we currently conduct . . . our activities and operations in substantial compliance with applicable laws and regulations . . . .")). As to the statements of fact, the mere existence of regulatory violations does not establish that Lumber Liquidators *lacked* compliance policies, personnel, and activities.[28] As to the statements expressing the Company's opinions regarding its regulatory compliance, a statement of opinion is only false "if the statement is false, disbelieved by its maker, and related to matters of fact which can be verified by objective evidence." *Nolte v. Capital One Fin. Corp.*, 390 F.3d 311, 315 (4th Cir. 2004). As already discussed, Plaintiffs fail to plead any facts establishing that the senior corporate officers who made these statements did *not* believe that Lumber Liquidators had a strong quality control and assurance program or was conducting its activities in substantial compliance with the law. *See* Section II *infra*. Nor do Plaintiffs adequately allege that Defendants knew, but failed to disclose, some material fact about the Company's inquiry into or knowledge concerning the opinions. *Corban v. Sarepta Therapeutics, Inc.*, 2015 WL 1505693, at *11 (D. Mass. Mar. 31, 2015) (rejecting omission theory where plaintiffs' allegations amounted to dispute over how to interpret drug testing results).

[28] To the extent that Plaintiffs attempt to plug this gaping hole in their pleadings with the Company's supposed admission that "Lumber Liquidators did not begin building a compliance team in China until December of 2014," Compl. ¶ 344, that tactic should be rejected. In other public statements, the Company has made it clear that it has had compliance personnel in China throughout the class period. (*See, e.g.*, Business Update Presentation attached to March 12, 2015 8-K, at 18, Ex. 2; Compl. ¶¶ 58, 240, 247.)

B. Alleged False Statements Regarding Financial Performance

Plaintiffs allege that every statement Lumber Liquidators made about its increase in gross margins and overall financial performance was false because the Company did not disclose that CARB and Lacey Act violations were contributing to those results. *See, e.g.*, Compl. ¶ 163. In particular, all of these financial statements are alleged to be false because (a) the supposed regulatory violations caused "the decrease in the Company's cost of product and increase in margins," (b) "a substantial portion of the Company's earnings and revenues were thereby earned as a result of the violation of these laws," and (c) "the Company's gross margin expansion was not sustainable." *Id.* ¶ 13. The problem with this sweeping accusation of financial fraud is that it cannot be substantiated by the actual allegations.

Lumber Liquidators' revenue totaled over $1 billion in 2013 and 2014. (2013 Form 10-K at 26-27, Ex. 3; 2014 Form 10-K at 29-30, Ex. 1.) Even if one assumes that a handful of Chinese mills sold Lumber Liquidators an undetermined amount of non-compliant laminate flooring at a 10-15% discount, this assumption utterly fails to demonstrate any significant financial impact from CARB violations. Similarly, any possible Lacey Act violations related to Lumber Liquidators' purchase of RFE oak could not have affected a "substantial portion" of the Company's revenue. As the Company has disclosed, less than 2% of its hardwood purchases (which, in turn, only make up 43% of its overall product purchases) consisted of oak purchased from northern China. (CSFB presentation at 24, attached to December 9, 2013 Form 8-K, Ex. 4.) In other words, less than 1% of the Company's overall purchases of products are possibly implicated by EIA's investigation into RFE logging and Xingjia. Even if every piece of oak that Lumber Liquidators purchased from northern China had been illegally sourced (and the Complaint contains no factual allegations that would support such an assumption), these purchases and subsequent sales to consumers would have accounted for an extremely small portion of the Company's revenues, not a "substantial" one.[29] Plaintiffs' failure to allege facts establishing that CARB or Lacey Act violations had any impact (and certainly no significant impact) on Lumber Liquidators' financial performance means that their claims based on the Company's financial disclosures must be dismissed. *See, e.g., Gross v. Summa Four, Inc.*, 93 F.3d 987, 995-96 (1st Cir. 1996) (general allegation that certain practices affected company's earnings are insufficient under Rule 9(b); plaintiff failed to offer particularized allegations because he did "not allege[] the amount of the putative overstatement or the net effect it had on the company's earnings"); *In re Daou Sys., Inc.*, 411 F.3d 1006, 1016-18 (9th Cir. 2005) (plaintiff must specifically plead effect of alleged misconduct on company's revenues).

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[29] In addition, nowhere in the Complaint is it alleged that the illegally harvested oak hardwood that the Company supposedly purchased was actually cheaper than similar, compliant products. The Complaint appears to assume that this is true, but offers no factual allegations in support of

Moreover, even if the supposed regulatory violations did have some financial impact on Lumber Liquidators, it is well-established that the Company was not required to disclose the existence of those violations. Plaintiffs do not allege that any of the financial results reported by Lumber Liquidators, including its gross margins, were inaccurate. Instead, they assert that the Company had a duty to disclose that these financial results were the result of illegal activities. As courts in this District and around the country have held, however, no such duty exists. *Iron Workers*, 432 F. Supp. 2d at 586-87 (companies have no "duty to disclose illegal and illicit activities"); *Weill v. Dominion Res., Inc.*, 875 F. Supp. 331, 337 (E.D. Va. 1994) ("[S]ecurities laws do not obligate defendants to reveal the culpability of their activities . . . ."); *see also In re Citigroup, Inc. Sec. Litig.*, 330 F. Supp. 2d 367, 377 (S.D.N.Y. 2004) ("[F]ederal securities laws do not require a company to accuse itself of wrongdoing."). Accordingly, unless Lumber Liquidators "reported income that it did not actually receive, the allegation that a corporation properly reported income that is alleged to have been, in part, improperly obtained is insufficient to impose Section 10(b) liability." *In re Marsh & McLennan Cos., Inc. Sec. Litig.*, 501 F. Supp. 2d 452, 470 (S.D.N.Y. 2006).[30]

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that assumption (indeed, the EIA Report does not state that the products were cheaper). *See Ashcroft v. Iqbal*, 556 U.S. 662, 679 (2009) (allegations that permit court to infer only "the mere possibility of misconduct" are insufficient).

[30] Plaintiffs also assert that the Company had a duty to inform the market that its gross margins were "not sustainable." *See, e.g.,* Compl. ¶ 174. In *Iron Workers*, the court found that in the absence of specific statements where the company "guaranteed that revenues would continue,"

IV. Plaintiffs Fail to Adequately Plead Loss Causation

Plaintiffs bear the burden of adequately pleading "loss causation, *i.e.*, that the defendant's material misrepresentation[s] or omission[s] caused the loss for which the plaintiff seeks to recover damages." *Katyle v. Penn Nat'l Gaming, Inc.*, 637 F.3d 462, 465 (4th Cir. 2011) (quotations and citations omitted). To do so, Plaintiffs must plead with specificity a "direct relationship" between their alleged loss and the alleged fraudulent conduct. *Id*. at 472. "The degree of specificity demanded is that which will 'enable the court to evaluate whether the necessary causal link exists.'" *Id.* at 471. (citations omitted).

Courts have recognized two possible ways of pleading loss causation: "(i) a corrective disclosure informed the market of the fraud, and the market reacted negatively; or (ii) the risk concealed from investors materialized and caused a foreseeable loss." *In re Francesca's Holdings Corp. Sec. Litig*., 2015 WL 1600464, at *18 (S.D.N.Y. Mar. 31, 2015). In this case, Plaintiffs rely solely on allegations of corrective disclosures, specifically alleging that each stock price decline they identify as contributing to their alleged loss was preceded by a disclosure of "new facts" that "partially corrected Defendants' prior misrepresentations and omissions." Compl. ¶¶ 353, 355, 357, 359, 365, 368. While it is possible to demonstrate that the "truth gradually emerged through a series of partial disclosures," these partial disclosures must be adequately alleged to have revealed "*new facts* suggesting [the defendant] had perpetrated a fraud on the market." *Katyle*, 637 F.3d. at 472-73 (emphasis added). In other words, the newly disclosed facts "must reveal to the market in some sense the fraudulent nature of the practices about which [the] plaintiff complains." *Id.* at 473. For the reasons shown below, Plaintiffs' allegations of partial "corrective disclosures" cannot satisfy their loss causation pleading burden.

The Zhou Post – Plaintiffs first point to the Zhou Post on June 22, 2013, in which Zhou claims that *one* of two wood samples he tested emitted excessive formaldehyde. It is clear that the Zhou Post did not "reveal" the "fraudulent nature of the practices about which the plaintiff

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no such duty existed. 432 F. Supp. 2d at 586. As in *Iron Workers*, Lumber Liquidators provided investors with no guarantees about its gross margins, and it therefore cannot be held liable for allegedly failing to disclose that they were "not sustainable."

complains." *Katyle*, 637 F.3d at 473. These alleged "practices" are the supposed scheme to improperly inflate the Company's gross margins through the sale of illegal or hazardous wood products constituting a "substantial portion of the Company's earnings and revenues." Compl. ¶ 13. Mr. Zhou's post, by merely claiming that one isolated sample of the Company's product exceeded the CARB standard in California, did not in any meaningful sense reveal this scheme.

For example, in *Metzler Investment GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049 (9th Cir. 2008), which the Fourth Circuit cited favorably in *Katyle*, the plaintiff alleged that Corinthian Colleges – a for-profit educational institution with 88 campuses in 22 states – engaged in fraudulent practices to maximize its federal funding. The plaintiff tried to plead loss causation by alleging that the fraud was revealed by a *Financial Times* story reporting that the Department of Education had investigated only *one* of the school's many campuses, found compliance deficiencies, and "placed [it] on 'reimbursement' status" as a result of its financial aid practices. *Id.* at 1057. The Ninth Circuit held that the *Financial Times* story was not a corrective disclosure because it did not "disclose[] – or even suggest[] – to the market that Corinthian was manipulating student enrollment figures *company-wide* in order to procure excess federal funding . . . . [and could not] be reasonably read to reveal *widespread* financial aid manipulation by Corinthian . . . ." *Id.* at 1063 (emphasis added). The Zhou Post is not a "corrective disclosure" for the same reasons.

The Government's Investigation – Plaintiffs suggest that the Company's September 27, 2013 announcement about the execution of search warrants at the Company's corporate offices constituted a partial corrective disclosure. Compl. ¶¶ 355-56. The announcement of a government investigation, however, cannot act as the revelation of a fraud. Indeed, every appellate court that has addressed the issue has held the disclosure of an investigation is *not* sufficient. *Loos v. Immersion Corp.*, 762 F.3d 880, 890 (9th Cir. 2014); *Meyer v. Greene*, 710 F.3d 1189, 1201 (11th Cir. 2013). As the Ninth Circuit explained, "at the moment an investigation is announced, the market cannot possibly know what the investigation will ultimately reveal." *Loos*, 762 F.3d at 890. Any related decline in the stock price "can only be attributed to market speculation about whether fraud has occurred. This type of speculation cannot form the basis of a viable loss causation theory." *Id*.

The Tilson Presentation – Plaintiffs argue that the Tilson Presentation on November 22, 2013 was a partial corrective disclosure. Compl. ¶¶ 357-58. But Fourth Circuit law is clear: corrective disclosures must reveal the "truth" through *new facts. Katyle*, 637 F.3d at 477. On its face, the Tilson Presentation is predicated entirely on existing public information about Lumber Liquidators, including the Zhou Post, the EIA report, and the Company's financial disclosures, and it contains no "new facts." Although Plaintiffs note that the Company's stock price dropped after the Tilson Presentation was made, *see* Compl. ¶¶ 20, 358, a stock price drop that results from a disclosure based on facts that were already known to the market cannot form the basis for loss causation. *See, e.g.*, *Teachers' Ret.*, 477 F.3d at 187; *Greene*, 710 F.3d at 1195-98.

That conclusion is not altered just because the Tilson Presentation, as analyst reports generally do, also contained opinions and analysis regarding the previously disclosed information. The Eleventh Circuit recently faced a virtually identical set of allegations – an analyst presentation that led to a stock-price drop – and held that the plaintiffs had failed to adequately allege loss causation. *Greene*, 710 F.3d at 1195-98. As that court found, "the mere repackaging of already-public information by an analyst or short-seller is simply insufficient to constitute a corrective disclosure." *Id.* at 1199. Indeed, "[i]f every analyst or short-seller's opinion based on already-public information could form the basis for a corrective disclosure, then every investor who suffers a loss in the financial markets could sue under § 10(b) using an analyst's negative analysis of public filings as a corrective disclosure. That cannot be – nor is it – the law." *Id.*

As in *Greene*, the Tilson Presentation sets forth some speculative opinions and conclusions about those previously-disclosed facts. (*See*, *e.g.*, Tilson Presentation at 10, 15, 18, 19, Ex. 14 ("*I believe* that a substantial fraction of LL's gross (and operating) margins expansion is due simply to buying the same products for less"; "*I think* it is likely that a meaningful percentage of the 51% of LL's wood sourced in Asia is from Chinese mills . . ."; "my *best guess* is that this is a big problem . . .") (emphases added).) These opinions and conclusions, however, are not "facts" by any stretch of the imagination – nor, tellingly, are they even described as such in the Presentation itself. Any stock price decline associated with the Tilson Presentation cannot support the existence of loss causation.

2Q 2014 Earnings Announcement – Plaintiffs assert that the Company's 2Q 2014 earnings announcement was a partial corrective disclosure. Compl. ¶¶ 359-64. This assertion is nonsensical. Lumber Liquidators reported that that it was experiencing a sales shortfall because of inventory constraints. *Id.* ¶ 361. The inventory was constrained, at least in part, because of "production delays" caused by the Company's enhancement of its "quality assurance requirements" in China and elsewhere. *Id.* ¶¶ 361-62. The sales shortfall and constrained inventory levels "led to shifts in our net sales mix that were adverse to gross margin." *Id.* ¶ 295. The actual decline in gross margin as compared to the prior year, however, was less than 1% (41.3% in 2013 2Q and 40.4% in 2014 2Q). (July 30, 2014 2Q 2014 Form 10-Q at 15, Ex. 34.)

Nothing in these disclosures presented "new facts" concerning Lumber Liquidators' CARB or Lacey Act compliance. The Company's decision to implement additional quality assurance requirements following the launching of a government investigation was prudent corporate governance, not an admission that any wrongdoing had taken place. *In re Alstom SA Sec. Litig.*, 406 F. Supp. 2d 433, 471 (S.D.N.Y. 2005) (remedial measures taken by company "more plausibly suggest that Alstom took the approach that would be reasonably followed by any prudent corporation when confronted with this type of crisis"). Moreover, to the extent that the new quality assurance requirements had an effect on gross margin, there was no indication in the public disclosures that this was the result of the discovery of either prior or current CARB or Lacey Act violations, as opposed to simply the stated production delays. *In re Omnicom Grp. Sec. Litig.*, 541 F. Supp. 2d 546, 552 (S.D.N.Y. 2008) ("[W]here a disclosure does not reveal the falsity of the alleged misstatements, it does not qualify as 'corrective.'").

February 25, 2015 Earnings Call – Plaintiffs fare no better when they attempt to plead loss causation based on the Company's disclosures, in a February 25, 2015 earnings call, that the

DOJ might file criminal charges related to its Lacey Act investigation and that it believed *60 Minutes* would run a negative report related to laminates support loss causation. Compl. ¶¶ 365-66. These disclosures did not reveal any previously hidden "truths" to investors. At best, as with the government investigation itself, any stock price drop related to the possibility of criminal charges "can only be attributed to market speculation about whether fraud has occurred. This type of speculation cannot form the basis of a viable loss causation theory." *Loos*, 762 F.3d at 890. Similarly, the fact that *60 Minutes* might run a negative story about laminates did not provide investors with any information concerning past CARB violations.

***60 Minutes* Report –** Plaintiffs final assertion, that the *60 Minutes* report on March 1, 2015 was a partial corrective disclosure, also is untenable. As courts have recognized in addressing securities fraud claims, there are "problems inherent in a news report from a television program like *60 Minutes, e.g.*, the reporter's biases, the editing of the interviews to tell a story . . . ." *Career Educ.*, 2006 WL 999988, at *6. Even putting those issues aside, the report makes clear that it is based almost entirely on *existing* allegations about excessive formaldehyde levels in Lumber Liquidators' flooring.

At the outset, *60 Minutes* interviewed the Executive Director of Global Community Monitor and his attorney about the testing they had done on Lumber Liquidators laminate flooring. That testing had been disclosed in a lawsuit filed *nine months earlier in July 2014.* Compl. ¶¶ 135-36. In that lawsuit, as in the *60 Minutes* report, Global Community claims to have tested numerous boxes of laminate flooring and found that "every single sample of Chinese-made laminate flooring from Lumber Liquidators failed to meet California formaldehyde emissions standards." *Id.* ¶ 136. *60 Minutes'* repetition of Global Community Monitor's allegations and its own similar testing was simply a repackaging of previously available information and cannot qualify as a corrective disclosure. *Teachers' Ret.*, 477 F.3d at 187; *Greene*, 710 F.3d at 1197-99.

In the end, the only "new facts" contained in the *60 Minutes* report were the purported revelations that certain laminate flooring sold to Lumber Liquidators was not – according to employees in *three* mills – CARB compliant and, as a result, was less expensive. Compl. ¶¶ 145-47. As with the Zhou Post, however, these allegations do not and cannot act as a corrective disclosure of a supposed scheme to improperly inflate the Company's gross margins through the sale of hazardous wood products constituting a "substantial portion of the Company's earnings and revenues." Compl. ¶ 13. At best, the *60 Minutes* report shows that there may have been CARB compliance issues at a handful of mills that sold an unknown amount of laminate flooring to Lumber Liquidators. *Metzler,* 540 F.3d at 1063-64 (rejecting alleged corrective disclosure that could not be said to have revealed a "widespread" fraud).

It is not enough for Plaintiffs to argue that based on a series of partial corrective disclosures the market "must have known" that the Company's earlier statements were false or misleading. *Katyle,* 637 F.3d at 477 (rejecting plaintiffs' proposed "holistic" reading of alleged partial corrective disclosures). While the partial disclosures do not have to provide a "fact-for-fact disclosure of the relevant truth," *id.* at 472-73, missing from the Complaint are *any* disclosures – whether considered individually or together – that revealed the Company's alleged fraudulent scheme. *See Loos*, 762 F.3d at 887-88 (announcements of disappointing earnings and investigations into revenue transactions insufficient partial corrective disclosures of alleged fraudulent accounting practices).

CONCLUSION

For these reasons, the Complaint should be dismissed in its entirety and with prejudice.[31]

[31] Plaintiffs also bring claims against each Individual Defendant under Section 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t(a), which under certain circumstances provides for secondary liability for "control persons," or those who exercised control over another person or entity that violated the securities laws. Compl. ¶¶ 92-97. But "a Section 20(a) claim will stand or fall based on the court's decision regarding the Section 10(b) claim." *Plymouth Cnty. Ret. Ass'n v. Primo Water Corp.*, 966 F. Supp. 2d 525, 552-53 (M.D.N.C. 2013); *see also Yates,* 744 F.3d at 894 n.8. Because Plaintiffs have failed to adequately allege any violations of Section 10(b) or Rule 10b-5, *see supra* §§ II-IV, the control person claims must be dismissed as well. *Id.*

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CERTIFICATE OF SERVICE

I hereby certify that on the 2nd day of June 2015, I will electronically file the foregoing with the Clerk of the Court using the CM/ECF system, which will then send a notification of such filing (NEF) to the following:

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